

Recent Developments

REALIGNMENT OF CORPORATE PARTY IN SHAREHOLDER'S DERIVATIVE SUIT

Smith v. Sperling, 354 U.S. 91 (1957)

Plaintiff, a citizen of New York and a shareholder in Warner Bros. Pictures, Inc., brought a shareholders' derivative suit in a federal district court against United Pictures, Inc. and Warner Bros., both Delaware corporations. Plaintiff's suit was based on "fraudulent wastage" of Warner Bros. assets caused by various contracts with United which were allegedly unfair and detrimental to Warner Bros.

Plaintiff's petition alleged that a demand upon the directors of Warner Bros. to sue would be futile since at least a majority of them had approved the contracts. The district court realigned Warner Bros. as a plaintiff and dismissed the action for a lack of federal diversity jurisdiction since there were then citizens of the same state, Delaware corporations, on both sides of the controversy. The basis for the realignment was a finding, at a preliminary trial, that the corporation was not in hands antagonistic to its own financial interests and there was a good faith exercise of directorial discretion in refusing to sue. In a five-to-four decision the Supreme Court held that it was error to realign the corporation; the proper procedure is to determine antagonism on the face of the pleadings and by the nature of the controversy.¹

Both the majority and minority opinions rely on *Doctor v. Harrington*² as authority for their particular positions. In that case the bill of complaint alleged that the defendant wrongdoers were in absolute control of the plaintiff shareholder's corporation. The circuit court realigned the corporation as plaintiff and dismissed the complaint for lack of diversity of citizenship.³ In support of the lower court's dismissal, the argument⁴ had been that a shareholder and his corporation have the

¹ Justice Douglas qualifies his test by stating that collusion may always be shown. 354 U.S. at 97; 28 U.S.C. § 1359 (1952). The dissent, written by Justice Frankfurter, agrees with the test used by the district court. The "preliminary trial" lasted fifteen days and the transcript was about 2,000 pages. 117 F. Supp. 781 (S.D. Cal. 1953), 68 HARV. L. REV. 195 (1954), 54 COLUM. L. REV. 629 (1954), 38 MINN. L. REV. 87 (1954), 40 VA. L. REV. 492 (1954). This opinion was affirmed in 237 F.2d 317 (9th Cir. 1956). *Swanson v. Traer*, 354 U.S. 114 (1957), is a companion case to the *Smith* case; for a discussion of the lower court's opinion in the *Swanson* case see 44 CAL. L. REV. 959 (1956).

² 196 U.S. 579 (1805).

³ An action will be dismissed for lack of diversity jurisdiction when any of the parties on one side of a controversy are of the same citizenship as any of the parties on the other side because there would be no "controversy" between citizens of different states. *Indianapolis v. Chase National Bank*, 314 U.S. 63,

same ultimate interests and therefore both must be plaintiffs.⁵ The Supreme Court reversed, stating:

The ultimate interest of the corporation made defendant may be the same as that of the stockholder made plaintiff, but the corporation may be under a control antagonistic to him, and made to act in a way detrimental to his rights. In other words, his interests and the interests of the corporation, may be made subservient to some illegal purpose. If a controversy hence arise, and other conditions of jurisdiction exist, it can be litigated in a Federal Court.⁶

The *Harrington* case is distinguishable from both the majority and minority opinions and its use as a precedent should be confined to a holding that a corporation *may* be a defendant when it is under the absolute control of the alleged wrongdoers.

From the reversal of the trial court's realignment in the *Harrington* case, it does not follow that there must be an acceptance of the pleader's arrangement of the parties in every case. The issue before the Court in the *Harrington* case was whether a corporation must always be a plaintiff as a matter of law. The bill of complaint alleged that the wrongdoers were in control of a majority of the voting power and of the actions of the corporation; this allegation of absolute control does not appear to be controverted by the answer.⁷ The Court rejected the argument that since a corporation and its shareholder have the same ultimate interests they both must be plaintiffs and, using the pleadings, held that a corporation *may* be a defendant—at least when the alleged wrongdoers are in absolute control of the corporation. The dissent's test of determining whether the corporation was in hands antagonistic to its own financial

69 (1941); *Strawbridge v. Curtis*, 7 U.S. (3 Cranch) 267 (1806); *Lavin v. Lavin*, 182 F.2d 870 (2d Cir. 1950).

⁴ The corporation also argued that shareholders were conclusively presumed to be citizens of the state in which the corporation was incorporated, this being its domicile. The Court rejected this theory as being a legal fiction at variance with the facts. There has been a great deal of controversy about whether a corporation should be considered a citizen within the meaning of the Constitution so as to allow it to litigate in the federal courts under the diversity clause. See *Green, Corporations as Persons, Citizens, and Possessors of Liberty*, 94 U. PA. L. REV. 202 (1945). For the contrary view see McGovney, *A Supreme Court Fiction*, 56 HARV. L. REV. 853, 1090 (1943).

⁵ There are eminent dicta which indicate that the corporation should always be aligned as plaintiff for purposes of diversity of citizenship. *Ashley v. Kieth Oil Corp.* 73 F. Supp. 37, 52-53 (D. Mass 1947). Judge Hand suggested, in *Lavin v. Lavin*, 182 F.2d 870, 871 (2d Cir. 1950), that the Supreme Court would probably align the corporation as plaintiff if the question arose again, which was proved wrong by the present case. For a discussion of Judge Hand's opinion in the *Lavin* case see 39 CAL. L. REV. 138 (1951) where it is suggested that legislation should be passed to allow federal diversity jurisdiction to cover a situation where a shareholder is without a state forum.

⁶ 196 U.S. at 587.

⁷ *Id.* at 582 and 588.

interests is entirely consistent with that holding, i.e., a corporation which is not under the control of the alleged wrongdoer may or may not be antagonistic to its own financial interests.⁸

Does the language of *Doctor v. Harrington* indicate a test which was to be used in future cases? At first blush it appears there is some merit to Justice Frankfurter's charge that the Court has overturned precedents of fifty years. In reading the language of the *Harrington* opinion it is pertinent to question why Justice McKenna even talked about "antagonistic" control in connection with diversity jurisdiction if the requisites for jurisdiction are to be decided "on the face of the pleadings and by the nature of the controversy." Naturally the shareholder and corporation will be antagonistic toward each other because the corporation's failure to sue upon demand of the shareholder shows irreconcilable conflict. This discussion of antagonism in the *Harrington* case, however, does not justify Justice Frankfurter's inference that the Court established a positive test for future jurisdictional alignment. The Court in the *Harrington* case was concerned only with the immediate question before it and did not contemplate a different fact situation, namely one where a corporation is not under the absolute control of the alleged wrongdoer. In support of the trial court's dismissal in the *Harrington* case the defendant's argument was, "although in form a defendant [it] is in legal effect on the same side of the controversy as the complainants . . . the Circuit Court had no jurisdiction, as the suit does not involve a controversy between citizens of different states."⁹ Justice McKenna was merely explaining why, in answer to this argument, a corporation does not always have to be a plaintiff and may be a defendant. Even though the ultimate interests are the same, the immediate ones may conflict and thus form the basis for jurisdiction through diversity of citizenship. The word "antagonistic" was used only in *explanation* of how the attitude of the corporation may thus be and no test of jurisdictional alignment was intended by the disputed clause: "The ultimate interests of the corporation made defendant may be the same as that of the stockholder made plaintiff, but the corporation may be under a control antagonistic to him. . . ."¹⁰ In a later case¹¹ Justice McKenna, in discussing the *Harrington* case, uses the word "antagonism" as a word of substance in connection with Rule 23(b)¹² which may be further evidence that the term was used in explaining his position in the *Harrington* case and not with an intent to establish a test for diversity jurisdiction.

⁸ 354 U.S. at 98.

⁹ 196 U.S. at 585-86.

¹⁰ *Id.* at 587, emphasis is the writer's.

¹¹ *Delaware and Hudson Co. v. Albany and Susquehanna Railroad Co.*, 213 U.S. 435 (1909).

¹² Rule 23(b) is discussed by the dissent, 354 U.S. at 106-108. Also see 3 MOORE, FEDERAL PRACTICE §§23.15-23.19 (2d ed. 1948); annot. 132 A.L.R. 193, 197-202 (1941).

None of the cases subsequent to *Harrington* seem to support the charge that precedents of fifty years have been overruled although some language, read out of context, might give that appearance. Many statements may be found, where it is said that the court will look beyond the pleadings and arrange the parties according to their actual interests. This language, however, is found where collusion is suggested or is a dictum without contemplation of the factual situation of the instant case where the shareholder's corporation is not under the control of the wrongdoer, and no new definitional scope is given to the doctrine of jurisdictional realignment.¹³

In *Indianapolis v. Chase National Bank*¹⁴ the Court realigned when it found that the plaintiff and one of the defendants were in accord on

¹³ (a) *City of Dawson v. Columbia Saving Fund, Safe Deposit, Title and Trust Co.*, 197 U.S. 178 (1905). The Court said it was their duty to look beyond the pleadings and arrange the parties according to their sides in the dispute, and realigned them saying, "no difference or collision of interest or action is alleged or even suggested."

(b) *Chicago v. Mills*, 204 U.S. 321 (1907). The Court refused to realign where the plaintiff and corporation had disagreed about the advisability of suing a third party. The main contention of this defendant was collusion, which the Court rejected, and the corporation did not appear to contest the shareholders' derivative action.

(c) *Venner v. Great Northern Railway Co.*, 209 U.S. 24 (1908). The Court found a "controversy" between the shareholder and corporation where injury was allegedly caused by those in control of the corporation and third parties. On these facts, this case is precisely like *Doctor v. Harrington* and, although there is much discussion of the issue of realignment, a fair interpretation of the Court's language seems to be merely a reaffirmation of the principle that a corporation may be a defendant under this fact situation.

(d) *Delaware and Hudson Co. v. Albany and Susquehanna Railroad Co.*, 213 U.S. 435 (1909). This case dealt with Equity Rule 94, now Rule 23(b), and not with jurisdiction.

(e) *Helm v. Zarecor*, 222 U.S. 32 (1911). The Court refused to realign the corporation as a plaintiff.

(f) *Hamer v. New York Railways Co.*, 244 U.S. 266 (1917). The trustee here was realigned where the Court ascertained that his real attitude was not hostile but friendly and the suit was an attempt to litigate in federal instead of state court.

(g) *Niles-Bement-Pond Co. v. Iron Moulders' Union Local No. 68*, 254 U.S. 77 (1920). No relief was prayed for by the plaintiff-shareholder against its corporation-defendant, essentially a subsidiary of plaintiff, and the Court therefore realigned.

(h) *Koster v. Lumberman's Mutual Casualty Co.*, 330 U.S. 518 (1947). This case dealt with forum non conveniens and did not decide any issue present in the *Sperling* case. The discussion of shareholders' derivative suits again reaffirms the doctrine of the *Harrington* case that a corporation may be a defendant. The lower federal courts are divided. See the cases collected in 3 MOORE, FEDERAL PRACTICE §23.21, note 11 at p. 3532 and also annot. 132 A.L.R. 193, 197-202, (1941). Also see *Schmidt v. Esquire, Inc.*, 210 F.2d 908 (7th Cir. 1954).

¹⁴ 314 U.S. 63 (1941), 40 MICH. L. REV. 1109 (1942), 90 PA. L. REV. 620 (1942).

the "primary and controlling matter in dispute. The rest is window-dressing designed to satisfy the requirements of diversity jurisdiction. Everything else in the case is incidental. . . ."¹⁵ This opinion, written by Justice Frankfurter, does lend some support to his dissent in the present case because the Court went beyond the pleadings¹⁶ and into the merits of the case by examining the record and weighing the issues to see which were primary and controlling. This case is distinguishable, however, because the controversy did not involve a shareholders' derivative action nor a determination of jurisdiction by a preliminary trial and the main question in the case was the determination of primary and second issues. Justice Jackson's dissent to the majority opinion takes the view that "the measure of jurisdiction should be taken from the pleadings, unless the claims are frivolous on their face,"¹⁷ which is the same position taken by the majority in the instant case.

The Court, in the present case, was confronted with essentially a new issue, not decided by *Doctor v. Harrington* or subsequent Supreme Court cases. The effect of the majority view is to decide the question of diversity jurisdiction on the arrangement and allegations in the pleadings¹⁸ unless the issue of collusion between the shareholder and the corporation is raised.¹⁹ Where the plaintiff-shareholder is of diverse citizenship, the defendant corporation has no defense on jurisdictional grounds although it may move for summary judgment where there is no genuine issue of fact,²⁰ or in the proper factual setting, might successfully assert the doctrine of *forum non conveniens*.²¹

Justice Frankfurter has consistently contended that federal diversity jurisdiction should be as narrow as possible and perhaps be abolished. This would relieve the federal courts of the burden in volume of cases and also alleviate the necessity for intensive examination of complex state law, resulting in the saving of time for consideration of federal and constitutional problems and thus improving the federal judiciary.²² There

¹⁵ *Id.* at 72.

¹⁶ *Id.* at 79 (dissent).

¹⁷ *Ibid.*

¹⁸ Compliance with Federal Rule 23(b) would seem to be all that is required although there are some differences between this and jurisdiction. *E.g.* in *Venner v. Great Northern Railway*, 209 U.S. 24 (1907), the Court rejected the notion that compliance with Rule 23(b) was a jurisdictional factor and consequently the lower court had the power to rule on a demurrer. For a discussion of this see 3 MOORE FEDERAL PRACTICE §23.23 (1948).

¹⁹ 28 U.S.C. §1359 (1952). This statute provides that a district court shall not have jurisdiction in a suit where any party has been collusively joined to confer diversity jurisdiction. Also FED. R. CIV. P. 23(b) requires an allegation by the shareholder that the suit is not collusive and he must allege with particularity the efforts which the shareholder used to secure the desired action and reasons for the failure to obtain the action or make the efforts.

²⁰ FED. R. CIV. P. 56, 12(b)(c).

²¹ *Koster v. Lumberman's Mutual Casualty Co.* *supra* note 13.

²² See Ball, *Revision of Federal Diversity Jurisdiction*, 28 ILL. L. REV.

is certainly merit in his argument that the original reason of providing an impartial forum no longer exists.²³ However, it is questionable whether his test of realignment would materially reduce the number of suits in federal courts.²⁴ Also, the constitutional right to change diversity jurisdiction of all lower federal courts is vested in Congress²⁵ and a reduction in federal diversity suits by the "confusing process of judicial constriction"²⁶ will not accomplish an orderly, clear cut, sweeping change which is usually better attained by legislation.

The majority view is preferable because: (1) it treats the corporation as any other litigant,²⁷ providing uniformity; (2) it will not significantly increase or decrease the number of cases litigated in federal courts; (3) it provides future litigants with greater predictability; (4) time and expense²⁸ will be saved by deciding the merits in federal court because if plaintiff loses at a preliminary trial he may still sue in the state court and if plaintiff wins at a preliminary trial he must then prove his case under state substantive law; (5) the corporation is not free to pretend neutrality and thereby cause dismissal of plaintiff's action in federal court; (6) the non-resident plaintiff will not be faced with the problem of no forum of action²⁹ (assuming other jurisdictional requisites are met³⁰); (7) the test is more congruous with the policy of following state substantive law when dealing with the merits of a cause of action;³¹ (8) it seems to give a more ordinary and uniform meaning to the word "controversy."³²

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356 (1933); Yntema and Jaffin, *Preliminary Analysis of Concurrent Jurisdiction*, 79 U. PA. L. REV. 869 (1931); Brown, *The Jurisdiction of Federal Courts Based on Diversity of Citizenship*, 78 U. PA. L. REV. 179 (1929).

²³ Frankfurter, *Distribution of Judicial Power Between United States and State Courts*, 13 CORNELL L.Q. 499, 520-30 (1928); abuses of federal jurisdiction by corporations are especially criticized at page 525.

²⁴ See 54 COLUM. L. REV. 629, 630-31 (1954).

²⁵ U.S. CONST., art III, §§1, 2; *Kline v. Burke Construction Co.*, 260 U.S. 226, 233-34, 24 A.L.R. 1077 (1922). Also see 28 U.S.C. §1332 (1952).

²⁶ 314 U.S. at 84, Justice Jackson's dissent to Justice Frankfurter's opinion.

²⁷ Cf. note 4, *supra*.

²⁸ The "preliminary trial" in this case lasted 15 days and the transcript was about 2,000 pages. 117 F. Supp. 781 (S.D. Cal. 1953). Under the minority view the corporation might have been precluded from defending a suit on the merits which it wished to defend, as, for example, an action by a strike suitor who would then be free to sue again in state court.

²⁹ See *International Shoe Co. v. Washington*, 326 U.S. 310, 319 (1945).

³⁰ 28 U.S.C. §1332 (1952).

³¹ 354 U.S. at 95; *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541 (1948); *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938).

³² Certainly if the case were litigated in any state court there would be sufficient "controversy" to allow a shareholder to suit his corporation.